TAX NEWS FLASH

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Canadian Budget 2016
Growing the Middle Class

On March 22, 2016 ("**Budget Day**"), Minister of Finance Morneau of the recently-elected Liberal Government tabled his first federal budget ("**Budget 2016**"), themed "Growing the Middle Class." The basic narrative underlying Budget 2016 is one that juxtaposes the challenges faced by "David" and "Neera," two individuals belonging to Canada's middle class, against "friends who earn more and are already talking about when they will retire." The narrative and underlying juxtaposition represents a clear change in policy and direction when compared to the previous Conservative government's general narrative of austerity.

Budget 2016 expands on one of the Government's first actions, taken on December 7, 2015, of introducing a tax cut for the middle class by reducing the second personal federal income tax rate to 20.5% from 22% and raising taxes on Canadians earning more than $200,000 by introducing a top federal income tax rate of 33% (which, in most provinces, translates into a combined federal and provincial top marginal income tax rate in excess of 50%). The Government's stated priorities in Budget 2016 include help and growth for the middle class, which, it says, is reflected in a revamped Canada Child Benefit, the elimination of poorly targeted tax breaks, the above-noted middle-class tax cut and establishment of a new top tax rate, additional investment in student financial assistance, and significant investments in infrastructure and innovation.

Budget 2016 also continues on the previous Government's theme of making the tax system fairer. To this end, Budget 2016 proposes a number of measures to prevent evasion and improve compliance, such as:

- Investing $444.4 million over five years for the Canada Revenue Agency ("**CRA**") to hire additional auditors and specialists, develop robust business intelligence infrastructure, increase verification activities, and improve the quality of investigative work. Budget 2016 projects a revenue impact of $2.6 billion over five years from the investment.

- Investing $351.6 million over five years for the CRA to improve its ability to collect outstanding tax debts. Budget 2016 projects that this will lead to the collection of an additional $7.4 billion in tax debt over five years.

Budget 2016 also continues on the previous Government's commitment to enhancing the integrity of the tax system. In the domestic context, Budget 2016 proposes key measures to:

- Prevent business owners from multiplying access to the $500,000 small business deduction using complex partnership and corporate structures;
- Ensure that investment income derived from an associated corporation's active business is ineligible for the small business deduction in certain circumstances;
- Ensure that associated corporations cannot avoid the $15 million taxable capital limit in certain circumstances;
- Close perceived loopholes that allow private corporations to use life insurance policies to distribute amounts tax-free that would otherwise be taxable;
- Expand the debt-parking rules to include transactions designed to avoid recognition of foreign currency gains;
- Prevent the asymmetrical recognition of gains and losses on derivatives by eliminating the ability of taxpayers to value derivatives that are an inventory by using the lesser of cost and fair market value method;
- Prevent the deferral of capital gains tax by investors in mutual fund corporations structured as switch funds; and
- Introduce a new rule that would effectively treat the portion of any gain realized on the sale of a linked note that is attributable to the variable return on the note as accrued interest on the note.

In the international context, Budget 2016 proposes to:

- Strengthen transfer pricing documentation by introducing country-by-country reporting for large multinational enterprises;
- Extend the application of the existing back-to-back loan rules to royalty arrangements and introduce a similar set of rules in the shareholder loan rules; and
- Narrow the application of the exception contained at subsection 212.1(4) of the *Income Tax Act* (Canada) (the "**Tax Act**") to the cross-border anti-surplus stripping rules in situations of perceived artificial increases in cross-border paid-up capital.

Budget 2016 also reaffirms the Government's commitment to the OECD base erosion and profit shifting (BEPS) project by noting that it is participating in international work to develop a multilateral instrument to streamline the implementation of treaty-related BEPS recommendations, including addressing treaty abuse.

What follows is a summary of the key income tax measures contained in Budget 2016. Notably absent are proposed changes to the stock options regime contained in the Tax Act or a change to the capital gains inclusion rate.

PERSONAL INCOME TAX MEASURES

Income Splitting Credit

Budget 2016 proposes to eliminate the income splitting tax credit, which allows couples with at least one child under the age of 18 to notionally transfer up to $50,000 of taxable income to their spouse for the purpose of reducing the couple's total income tax liability by up to $2,000.

Labour-Sponsored Venture Capital Corporations Tax Credit

Budget 2016 proposes to restore the federal labour-sponsored venture capital corporations ("**LSVCC**") tax credit from 5% to 15% for share purchases of provincially registered LSVCCs prescribed under the Tax Act for the 2016 and subsequent taxation years. The federal LSVCC tax credit for federally registered LSVCCs will remain at 5% for the 2016 taxation year and be eliminated for the 2017 and subsequent taxation years.

Teacher and Early Childhood Educator School Supply Tax Credit

Budget 2016 proposes to introduce a teacher and early childhood educator school supply tax credit, which allows an eligible educator to claim a 15% refundable tax credit based on an amount of up to $1,000 in expenditures made by the eligible educator in a taxation year for eligible supplies, as long as certain conditions are met.

Mineral Exploration Tax Credit for Flow-Through Share Investors

Budget 2016 proposes to extend the eligibility of the mineral exploration tax credit for one year to flow-through share agreements entered into on or before March 31, 2017. The mineral exploration tax credit is equal to 15% of specified mineral exploration expenses incurred in Canada and "flowed-through" to flow-through share investors.

Children's Fitness and Arts Tax Credit

Budget 2016 proposes to phase out the children's fitness and arts tax credits by reducing the 2016 maximum eligible amounts to $500 from $1,000 for the children's fitness tax credit (which will remain refundable for 2016) and to $250 from $500 for the children's arts tax credit. Both credits will be eliminated in 2017 and subsequent years.

Top Marginal Income Tax Rate – Consequential Amendments

In order to reflect the new top personal federal tax rate of 33% on taxable income in excess of $200,000, Budget 2016 proposes the following amendments that will: (1) provide a 33% charitable donation tax credit on donations above $200 to *inter vivos* trusts; (2) apply the new 33% top rate on excess employee profit sharing plan contributions; (3) increase from 28% to 33% the tax rate on personal services business income; (4) amend the definition of "relevant tax factor" in the foreign affiliate rules to reduce the relevant tax factor from the current 2.2 to 1.9; (5) amend the capital gains refund mechanism for mutual fund trusts to reflect the new 33% top rate in the formulas that are used in computing refundable tax; (6) increase the Part XII.2 tax rate on the distributed income of certain trusts from 36% to 40%; and (7) amend the recovery tax rule for qualified disability trusts to refer to the new 33% top rate. These measures will apply

to the 2016 and subsequent taxation years. However, the charitable donation tax credit measure will be limited to donations made after the 2015 taxation year.

BUSINESS INCOME TAX MEASURES

Expanding Tax Support for Clean Energy and Electric Vehicle Charging Stations

Class 43.1 and 43.2 of Schedule II to the Tax Act provides accelerated CCA rates (30% and 50%, respectively, on a declining-balance basis) for investments in specified clean energy generation and conservation equipment. Budget 2016 proposes to expand these classes to include electric vehicle charging stations and related equipment. This measure will apply in respect of property acquired for use on or after Budget Day that has not been used or acquired for use before Budget Day.

Small Business Tax Rate

Budget 2016 proposes to halt the gradual reductions to the small business tax rate that are currently legislated for 2017, 2018 and 2019 and maintain the rate at 10.5% after 2016. Budget 2016 also proposes to maintain the current gross-up factor and dividend tax credit rate applicable to non-eligible dividends at 17% and 21/29 of the gross up amount, respectively.

Multiplication of the Small Business Deduction

Budget 2016 proposes changes to address concerns about partnership and corporate structures that multiply access to the small business deduction. With respect to partnerships, Budget 2016 proposes to extend the specified partnership income rules to partnership structures in which a Canadian-controlled private corporation ("**CCPC**") provides (directly or indirectly, in any manner whatever) services or property to a partnership during a taxation year of the CCPC where, at any time during the year, the CCPC or a shareholder of the CCPC is a member of the partnership or does not deal at arm's length with a member of the partnership.

In general terms, Budget 2016 proposes to deem a CCPC to be a member of a partnership throughout a taxation year if: (1) it is not otherwise a member of the partnership in the taxation year; (2) it provides services or property to the partnership at any time in the taxation year; (3) a member of the partnership does not deal at arm's length with the CCPC, or is a shareholder of the CCPC, in the taxation year; and (4) it is not the case that all or substantially all of the CCPC's active business income for the taxation year is from providing services or property to arm's length persons other than the partnership.

A CCPC that is a member of a partnership (including a deemed member) will have its active business income from providing services or property to the partnership deemed to be partnership active business income. Also, the specified partnership income limit of a deemed member of a partnership will initially be nil (as it does not receive any allocations of income from the partnership). However, an actual member of the partnership who does not deal at arm's length with a deemed member of the partnership will be entitled to notionally assign to the deemed member all of or a portion of the actual member's specified partnership income limit in respect of a fiscal period of the partnership that ends in the deemed member's taxation year.

Where the actual partner is an individual, the assignable specified partnership income limit of all members of the partnership will be determined as if they were corporations.

With respect to corporations, Budget 2016 proposes to disqualify a CCPC's active business income from the small business deduction where the CCPC provides services or property (directly or indirectly, in any manner whatever) in its taxation year to a private corporation where, at any time during the year, the CCPC, one of its shareholders, or a person who does not deal at arm's length with such shareholder has a direct or indirect interest in the private corporation. However, this proposal will not apply to a CCPC if all or substantially all of its active business income for the taxation year is earned from providing services or property to arm's length persons other than the private corporation. A CCPC will be entitled to assign all or a portion of its unused business limit to one or more CCPCs that are that ineligible for the small business deduction under this proposal because they provided services or property to the private corporation. The amount of active business income earned by a CCPC from providing services or property to the private corporation that will be eligible for the small business deduction (subject to the CCPC's own business limit) will be the least of: (1) the CCPC's income from providing services or property to the private corporation; (2) the amount, if any, of the private corporation's unused business limit — for its taxation year(s) ending in the taxation year of the CCPC in which it provided services or property to the private corporation — that is assigned to the CCPC; and (3) the amount determined by the Minister of National Revenue to be reasonable in the circumstances. This measure will apply to taxation years that begin after March 22, 2016. However, a private corporation will be entitled to assign all or a portion of its unused business limit in respect of its taxation year that begins before and ends on or after Budget Day.

Avoidance of the Business Limit and the Taxable Capital Limit

Two corporations that are associated because they are associated with the same third corporation will not be treated as being associated with each other if the third corporation is not a CCPC or, if it is a CCPC, it elects not to be associated with the other two corporations for the purpose of determining entitlement to the small business deduction. The effect of this exception is that the third corporation cannot itself claim the small business deduction (if it is a CCPC), but the other two corporations may each claim a $500,000 small business deduction subject to their own taxable capital limit. However, this exception does not affect the associated corporation status for the purpose of treating a CCPC's investment income as active business income eligible for the small business deduction if that income is derived from the active business of an associated corporation.

Budget 2016 proposes to amend the Tax Act to ensure that investment income derived from an associated corporation's active business will be ineligible for the small business deduction and be taxed at the general corporate income tax rate where the exception to the deemed associated corporation rule applies. In addition, where this exception applies, Budget 2016 proposes that the third corporation will continue to be associated with each of the other corporations for the purpose of applying the $15 million taxable capital limit in relation to the small business deduction. This measure will apply to taxation years that begin on or after Budget Day.

Consultation on Active Versus Investment Business

Budget 2016 specifies that the Government is not proposing any modification to the rules applicable to the circumstances in which income from a business, the principal purpose of which is to earn income from property, should qualify as active business income and therefore potentially be eligible for the small business deduction.

Transfers of Life Insurance Policies

A policyholder can transfer an interest in a life insurance policy to a non-arm's length person and the proceeds received by the policyholder will be deemed to be the cash surrender value of the interest in the policy transferred. In many cases, due to changes in the ratings of the insured, increases in the cost of providing insurance or other factors, the fair market value of the policy could be far higher than the cash surrender value of the policy. This permitted individual policyholders to effectively remove retained earnings from a non-arm's length transferee corporation on a tax-free basis by transferring an interest in their policy to the corporation for full fair market value consideration.

Budget 2016 proposes amendments to the policy transfer rule that will include the amount, if any, by which the fair market value of any consideration given exceeds the cash surrender value in both the proceeds of the transferring policyholder and the cost to the transferee of the interest in the policy acquired. In addition, if a corporation acquires a life insurance policy as a result of a capital contribution of such a policy, any resulting increase in the paid-up capital or adjusted cost base of any shares of the corporation will be limited to the deemed proceeds.

This measure will apply to dispositions that occur on or after Budget Day.

Budget 2016 also proposes (with retrospective effect) to change the calculation of the capital dividend account of a corporation that acquired a life insurance policy prior to Budget Day in circumstances where the fair market value consideration paid by the corporation exceeded the cash surrender value of the interest in the policy transferred to the corporation.

Under the new rule, the amount added to the capital dividend account of a corporation that has received a death benefit on or after Budget Day, will be reduced by the amount, if any, by which the consideration paid by the corporation exceeded the cash surrender value at the time of transfer.

The change will, in effect, reduce the amount of the tax-free capital dividends the corporation would otherwise have been permitted to pay by an amount equal to the amount, if any, by which the consideration paid by the corporation and received by the transferring policyholder free of tax exceeds the cash surrender value of the policy.

Budget 2016 further provides that where a corporation has acquired a life insurance policy before Budget Day as a capital contribution from the policyholder, any increase in the adjusted cost base and the paid-up capital of the shares of the corporation is effectively limited to the cash surrender value of the policy transferred.

Similar rules will apply in the partnership context to avoid an increase in the adjusted cost base of any partnership that has received a life insurance policy in similar circumstances.

Eligible Capital Property

Budget 2016 proposes to repeal the eligible capital property regime ("**ECP**"), replace it with a new capital cost allowance ("**CCA**") class available to business and provide rules to transfer taxpayers' existing cumulative eligible capital ("**CEC**") pools to the new CCA class.

Under this proposal, a new class of depreciable property for CCA purposes will be introduced. Expenditures that are currently added to CEC (at a 75% inclusion rate) will be included in the new CCA class at a 100% inclusion rate. Because of this increased expenditure recognition, the new class will have a 5% annual depreciation rate (instead of 7% of 75% of eligible capital expenditures). To retain the simplification objective, the existing CCA rules will generally apply, including rules relating to recapture, capital gains and depreciation (e.g. the "half-year rule").

Due to the broad definition of "property" in the Tax Act, which includes a right of any kind whatever, most, but not all, eligible capital expenditures and eligible capital receipts relate to acquisitions or dispositions of specific property and consequently will result in an adjustment to the balance of the new CCA class when the specific property is acquired or disposed. These amounts will also be relevant in the calculation of recapture and gains for the specific property.

Special rules will apply in respect of goodwill and in respect of expenditures and receipts that do not relate to a specific property of the business that would be eligible capital expenditures or eligible capital receipts under the ECP regime. Such expenditures and receipts will be accounted for by adjusting the capital cost of the goodwill of the business. Every business will be considered to have goodwill associated with it, even if there had not been an expenditure to acquire goodwill. An expenditure that did not relate to property will increase the capital cost of the goodwill of the business and, consequently, the balance of the new CCA class.

A receipt that did not relate to a specific property will reduce the capital cost of the goodwill of the business and, consequently, the balance of the new CCA class by the lesser of the capital cost of the goodwill (which could be nil) and the amount of the receipt. If the amount of the receipt exceeds the capital cost of the goodwill, the excess will be a capital gain. Previously deducted CCA will be recaptured to the extent that the amount of the receipt exceeds the balance of the new CCA class.

Under the proposal, CEC pool balances will be calculated and transferred to the new CCA class as of January 1, 2017. The opening balance of the new CCA class in respect of a business will be equal to the balance at that time of the existing CEC pool for that business. For the first ten years, the depreciation rate for the new CCA class will be 7% in respect of expenditures incurred before January 1, 2017.

Some receipts received after the time at which the new rules are implemented could relate to property acquired, or expenditures otherwise made, before that time. In this regard, certain qualifying receipts will reduce the balance of the new CCA class at a 75% rate. Receipts that qualify for the reduced rate will generally be receipts from the disposition of property, the cost of which was included in the taxpayer's CEC, and receipts that do not represent the proceeds of disposition of property. The total amount of such qualifying receipts, for which only 75% of the receipt will reduce the new CCA class, will generally equal the amount that could have been

received under the ECP regime before triggering an ECP gain. This rule will ensure that receipts do not result in excess recapture when applied to reduce the balance of the new CCA class.

A consequence of such a regime change might be to trigger refundable tax at the corporate level on the sale of such goodwill (since the gain so realized would be on the sale of a depreciable capital property), which does not arise under the current regime.

Budget 2016 also proposes two special rules to simplify the transition for small businesses to the new regime. First, to allow small initial balances to be eliminated quickly, a taxpayer will be permitted to deduct as capital cost allowance, in respect of expenditures incurred before 2017, the greater of $500 per year and the amount otherwise deductible for that year. This additional allowance will be provided for taxation years that end prior to 2027. Second, in the past, many businesses have had relatively small CEC balances, which were solely due to their incorporation expenses. To reduce compliance burdens in respect of these expenses, a separate business deduction will be provided for these expenditures, such that the first $3,000 of these expenditures will be treated as a current expense rather than being added to the new CCA class. This will allow approximately 80% of newly incorporated businesses to deduct the full amount of the incorporation expenses in their initial year.

These measures will apply as of January 1, 2017.

Taxation of Switch Fund Shares

Some mutual fund corporations are organized as “switch funds,” which offer investors the ability to invest in different classes of shares of the corporation with each class of shares offering the investor exposure to different types of assets. Investors in such mutual fund corporations are able to exchange shares of one class for shares of another class on a tax-deferred basis under section 51 of the Tax Act, thereby switching their economic exposure from one pool of assets to another pool of assets on a tax-deferred basis. Such a deferral advantage is not generally available to taxable investors investing in mutual fund trusts or on their own account directly in securities. Consequently, Budget 2016 proposes to amend the Tax Act so as to deny the automatic tax-deferral that would otherwise arise on an internal exchange or “switch” of shares of a mutual fund corporation (or investment corporation) so that the investor will be considered to have disposed of the shares at fair market value. The measure will not apply to exchanges or switches where the shares received on the exchange differ only in respect of management fees or expenses to be borne by investors or otherwise derive their value from the same portfolio or fund within the corporation.

These measures will apply to dispositions of switch fund shares that occur after September 2016. Budget 2016 does not contain any draft legislation in furtherance of this measure.

Taxation of Linked Notes – Secondary Market Sales

A linked note is a debt instrument, the return on which is linked in some manner to the performance of one or more reference assets. Oftentimes, the return, if any, is payable by the issuer of the note to its holder only at maturity. In order to guard against the deferral advantage that would otherwise be afforded to the holder of a linked note, the Tax Act contains a series of rules that deem interest to accrue on a typical linked note on an annual basis. However, based

on favourable rulings issued by the CRA, investors generally take the position that there is no deemed accrual of interest on a typical linked note under these rules prior to the time that some amount payable at maturity becomes determinable. Accordingly, recognition of any amount under a typical linked note is generally deferred until the taxation year of the holder in which the return becomes determinable, which is generally shortly before maturity.

However, rather than hold a linked note until maturity, some investors, who hold their linked notes as capital property, sell them into a secondary market that may develop, rather than holding them until maturity, and take the position that no amount in respect of the return on the linked note is accrued interest as at the date of sale. The sale, in effect, converts the return on the linked notes from ordinary income to capital gains, only one half of which is included in income.

Budget 2016 proposes to amend the Tax Act so that the return on a linked note retains the same character whether it is earned at maturity or reflected in a secondary market sale. The proposed deeming rule, contained at proposed subsection 20(14.2) of the Tax Act, will treat any gain realized on the sale of a linked note as interest that accrued on the debt obligation for a period commencing before the time of the sale and ending at that time. Foreign currency fluctuations will be ignored for these purposes. Similarly, the portion of the return on the note that is based on a fixed rate of interest will be excepted.

These measures will apply to sales of linked notes that occur after September 2016.

Debt-Parking to Avoid Foreign Exchange Gains

Budget 2016 proposes to expand the debt-parking rules so that any accrued foreign exchange gain on a foreign currency debt will be realized when the debt becomes a parked obligation. As a result, a debtor will be deemed to have made the gain, if any, that it otherwise would have made if it had paid an amount (expressed in the currency in which the debt is denominated) in satisfaction of the debt equal to: (i) where the debt becomes a parked obligation, the amount for which the debt was acquired, and (ii) in other cases, the fair market value of the debt.

To this end, a foreign currency debt will become a parked obligation at a particular time where:

(i) at that time, the current holder of the debt does not deal at arm's length with the debtor (or, where the debtor is a corporation, has a significant interest (i.e. 25% of votes or value either alone or together with non-arm's length persons) in the corporation), and

(ii) at any previous time, a person who held the debt dealt at arm's length with the debtor (and, where the debtor is a corporation, did not have a significant interest in the corporation).

Budget 2016 also proposes a series of exceptions to these rules so that a foreign currency debt will not become a parked obligation in the context of certain *bona fide* commercial transactions (such as an acquisition of debt where the holder also acquires a significant interest in, or control of, the debtor as part of the series and one of the main purposes of the transaction or series is not to avoid a foreign exchange gain). Similarly, a change in status between the debtor and

holder (from arm's length to not) will not trigger the application of these rules unless one of the main purposes of the transaction or series that gave rise to the change in status was to avoid a foreign exchange gain. Financially distressed debtors will also find relief similar to the deductions currently available to financially-distressed debtors that realize an income inclusion under the debt forgiveness rules.

These measures will apply to a foreign currency debt that meets the conditions to be a parked obligation on or after Budget Day, but there will be an exception where the conditions are met prior to 2017 as a result of a written agreement entered into before Budget Day. Budget 2016 does not contain any draft legislation in furtherance of this measure.

Valuation for Derivatives

Section 10 of the Tax Act permits a taxpayer to value each inventory property at the lower of its cost and its fair market value at the end of the taxation year. Under this method, if the fair market value of an inventory at the end of the taxation year is lower than its cost, the difference is deductible in computing the taxpayer's income for the year. The lower of cost and market method for valuing inventory effectively permits a taxpayer to recognize losses on inventory on an accrual basis, but gains on the same property are recognized only when the inventory is ultimately sold.

Budget 2016 proposes to exclude derivatives from the application of the inventory valuation rules while maintaining the status of such property as inventory. This is a response to the recent decision of the Tax Court of Canada in *Kruger v. R.*, 2015 D.T.C. 1127, which held that a derivative that provides rights to a taxpayer and is held on income account would be considered inventory (in that case, the Tax Court of Canada permitted the taxpayer to value its purchased foreign exchange option contracts in accordance with subsection 10(1) of the Tax Act).

Budget 2016 proposes that subsection 10(15) of the Tax Act be added so as to deem any property of a taxpayer that is a swap agreement, forward purchase or sale agreement, forward rate agreement, futures agreement, option agreement or any similar agreement not to be inventory of the taxpayer for purposes of section 10 of the Tax Act. Further, proposed paragraph 18(1)(x) of the Tax Act would specifically provide that no deduction may be claimed by a taxpayer in respect of any reduction in a taxation year of the value of a property if: (i) the taxpayer utilizes the lower of cost and market method in valuing property, (ii) the property is described in proposed subsection 10(15) of the Tax Act, and (iii) the property is not disposed of by the taxpayer in the year.

These measures will apply to derivatives entered into on or after Budget Day. It appears that taxpayers will be able to continue employing the lower of cost and market method in respect of derivatives entered into before Budget Day that are properly characterized as an inventory.

INTERNATIONAL INCOME TAX MEASURES

Base Erosion and Profit Shifting (BEPS)

In response to the OECD's release of final reports from the BEPS project in October 2015 and in furtherance of its endorsement of the package of recommendations developed under the

BEPS project, Budget 2016 proposes new legislation to strengthen transfer pricing documentation by introducing country-by-country reporting for large multinational enterprises.

Budget 2016 also notes that it will act on certain other recommendations from the BEPS project as follows:

- The CRA is and will be applying revised international guidance on transfer pricing by MNEs;
- Canada is participating in international work to develop a multilateral instrument to streamline the implementation of treaty-based BEPS recommendations, including addressing treaty abuse; and
- The CRA will undertake the spontaneous exchange of tax rulings with other tax administrations that could potentially give rise to BEPS concerns in the absence of such exchanges.

Transfer Pricing and Country-by-Country Reporting

Budget 2016 proposes to implement country-by-country reporting to MNEs with total annual consolidated group revenue of EUR750 million or more. Where such an MNE has an ultimate parent that is resident in Canada (or, in some cases, a Canadian subsidiary that is designated as a surrogate for filing purposes), it will be required to file a country-by-country report with the CRA within one year of the end of its fiscal year to which the report relates. In general, a country-by-country report will include the global allocation, by country, of key variables for the MNE, including revenue, profit, tax paid, stated capital, accumulated earnings, number of employees, tangible assets and the main activities of each subsidiary.

A country-by-country report received by a particular jurisdiction will be automatically exchanged with each other jurisdiction in which the MNE operates, provided that, in each case, the other jurisdiction has implemented country-by-country reporting, the two jurisdictions have an appropriate legal framework for the automatic exchange of information, and they have entered into a competent authority agreement relating to country-by-country reporting. First exchanges are expected to occur by June 2018.

Budget 2016 does not contain any draft legislation in furtherance of this measure, but instead notes that draft legislative proposals will be released for comment in the coming months.

Revised Transfer Pricing Guidance

Budget 2016 announces that the CRA will adopt and apply the revisions contained in the Transfer Pricing Guidelines emanating from the BEPS project in administering the arm's length principle mandated under Canada's transfer pricing rules at section 247 of the Tax Act. However, there are two areas in which the revisions to the Transfer Pricing Guidelines are not yet complete (namely, the development of a threshold for the proposed simplified approach to low value-adding services and the definition of risk-free and risk-adjusted returns for minimally functional entities) and in respect of which the CRA will not be adjusting its administrative

practices at this time. Budget 2016 notes that Canada will decide on a course of action with regards to these measures after the outstanding work is complete.

Treaty Abuse & Treaty Shopping

Budget 2016 confirms Canada's commitment to consider the inclusion of either a general anti-abuse rule that uses the criterion of the principal purpose of an arrangement or transaction was to obtain treaty benefits in a way that is not in accordance with the object and purpose of the relevant treaty or the use of a more mechanical limitation on benefits rule in its tax treaties going forward. Budget 2016 also notes that amendments to Canada's existing tax treaties to include a treaty general anti-abuse rule could be achieved through bilateral negotiations, the multilateral instrument that is expected to be developed in 2016, or a combination of the two. Budget 2016 highlights Canada's participation in international work to develop a multilateral instrument which would streamline the implementation of treaty-related BEPS recommendations, including treaty abuse.

Spontaneous Exchange of Tax Rulings

Budget 2016 confirms the Government's intention to implement the BEPS minimum standard for the spontaneous exchange of certain tax rulings in 2016 with other jurisdictions that have similarly committed. The framework developed by BEPS for the spontaneous exchange of certain rulings covers: (i) rulings related to preferential regimes, (ii) cross-border unilateral advance pricing arrangements, (iii) rulings giving a downward adjustment to profits, (iv) permanent establishment rulings, (v) conduit rulings, and (vi) any other type of ruling agreed to in the future.

Cross-Border Surplus Stripping

Budget 2016 highlights a concern of the Government with some non-resident taxpayers that may have sought to increase the paid-up capital ("PUC") in the shares of a Canadian subsidiary corporation by transferring high value shares of a foreign corporation (that, in turn, owns low-PUC shares of a second Canadian subsidiary) to its Canadian subsidiary. The foreign corporation would then typically transfer or distribute the shares of the lower-tier Canadian subsidiary to the upper-tier Canadian subsidiary and avoid the application of the anti surplus-stripping rule contained at section 212.1 of the Tax Act in reliance on an exception contained at subsection 212.1(4) of the Tax Act. Subsection 212.1(4) provides a wholesale exception from the application of section 212.1 of the Tax Act in respect of a disposition of shares of a Canadian corporation by a foreign corporation to another Canadian corporation (the "Canadian purchaser corporation") that controls, immediately before the disposition, the vending foreign corporation.

Budget 2016 proposes to "clarify" that the exception contained in subsection 212.1(4) of the Tax Act does not apply where a non-resident both: (i) owns, directly or indirectly, shares of the Canadian purchaser corporation, and (ii) does not deal at arm's length with the Canadian purchaser corporation. Budget 2016 also proposes to "clarify" the application of section 212.1 of the Tax Act by deeming the non-resident parent of the Canadian purchaser corporation to receive non-share consideration from the Canadian purchaser corporation in the course of such reorganizations (the quantum will be determined by reference to the fair market value of the

lower-tier Canadian subsidiary corporation shares received by the Canadian purchaser corporation). It is difficult to understand how such a specific set of conditions that do not currently appear in the legislation might be of a clarifying nature.

These measures will apply in respect of dispositions occurring on or after Budget Day. A series of proposed technical amendments giving effect to these proposals are included in Budget 2016.

Extension of Back-to-Back Rules

Budget 2016 proposes to build upon the existing back-to-back loan rules applicable in respect of interest by:

- Extending their application to rents and royalties;
- Adding character substitution rules;
- Adding back-to-back loan rules to the existing shareholder loan rules in the Tax Act; and
- Clarifying the application of the back-to-back loan rules to multiple-intermediary structures.

Back-to-back loan rules for rents, royalties and similar payments

Budget 2016 proposes to extend the existing back-to-back loan rules for interest to royalty arrangements by deeming the payment of an amount by a Canadian-resident person in respect of a particular lease, license or similar agreement to a person or entity that is resident in a treaty country that is subject to withholding tax at one rate (the "intermediary") to, instead, be paid directly to another non-resident person where the withholding tax rate would otherwise be higher in circumstances where the intermediary has an obligation to pay an amount to such non-resident person in respect of a lease, license or similar agreement, or of an assignment or an instalment sale, and one of the following two conditions is met:

- The amount that the intermediary is obligated to pay is established, *in whole or in part*, by reference to: (i) the royalty payment made by, or the royalty payments obligation of, the Canadian resident person, or (ii) the fair market value of property, any review, profits, income or cash flow from property, or any other similar criteria in respect of property where a right to use the property is granted in connection with the Canadian resident payer, or
- It can reasonably be concluded based upon all the facts and circumstances that the arrangement between the Canadian resident and the intermediary was entered into or permitted to remain in effect because the arrangement between the intermediary and other non-resident was, or was anticipated to be, entered into.

The application of these rules, as described, would appear to allow the CRA to reassess arrangements such as those employed in the case of *Velcro Canada Inc. v. R.*, 2012 D.T.C. 1100, on purely a domestic legislative basis without having to resort to a "beneficial ownership"

challenge under an applicable treaty in order to deny treaty benefits (where it was not successful).

These measures will apply to royalty payments made after 2016. Budget 2016 does not contain any draft legislation in furtherance of this measure.

Character Substitution Rules

Budget 2016 also proposes to extend the back-to-back loan rules to prevent their avoidance through the substitution of economically similar arrangements between the intermediary and another non-resident person, such as where: (i) interest is paid by the Canadian resident to the intermediary, but royalties are paid by the intermediary to the other non-resident, (ii) royalties are paid by the Canadian resident to the intermediary, but there is a loan between the intermediary and other non-resident, or (iii) interest or royalties are paid by the Canadian resident to the intermediary and the other non-resident holds shares of the intermediary that include certain obligations to pay dividends or satisfy certain other conditions (e.g. they are redeemable or cancellable).

Under the character substitution rules, a back-to-back arrangement will exist where a sufficient connection is established between (i) the arrangement under which the interest or royalty payment is made from Canada, and (ii) the intermediary's obligations in each of the three situations described above. Where such a back-to-back arrangement is found to exist, an additional payment of the same character as that paid by the Canadian resident to the intermediary will be deemed to have been made directly by the Canadian resident to the other non-resident.

These measures will apply to interest and royalty payments made after 2016. Budget 2016 does not contain any draft legislation in furtherance of this measure.

Back-to-Back Shareholder Loan Rules

Budget 2016 highlights a concern that the domestic shareholder loan rules contained at subsection 15(2) of the Tax Act can be circumvented by interposing a third-party intermediary that is not connected to the shareholder between the lending corporation and the shareholder, thereby avoiding an income inclusion in the domestic context or withholding tax in the international context. For example, instead of making a loan to the shareholder, the corporation might make a loan to the unconnected intermediary that might, in turn, make the loan to the shareholder. To address this concern, Budget 2016 proposes to amend the shareholder loan rules to include rules that are similar to the existing back-to-back loan rules, except that the proposed rules will apply to debts owing to Canadian-resident corporations rather than debts owing by Canadian-resident taxpayers.

Where these rules apply, the shareholder will be deemed to be indebted directly to the corporation in an amount similar to the amount that would be computed under the existing back-to-back loan rules, thereby triggering the application of the shareholder loan rules.

According to Budget 2016, a back-to-back shareholder loan arrangement will be considered to exist where a particular person or partnership that is not connected with the shareholder (the "intermediary") is owed an amount by the shareholder and one of the following two conditions is met:

- The intermediary owes an amount to the Canadian-resident corporation on either a limited-recourse basis or in circumstances where it can reasonably be concluded that the debt became owing or was permitted because the secondary debt was or was anticipated to be entered into, or

- The intermediary has a "specified right" in respect of a particular property (e.g. a right to mortgage, hypothecate, assign, pledge, or encumber the property to secure payment or to use, invest, sell or otherwise dispose of, or in any way alienate the property) that was granted by the Canadian-resident corporation and its existence is required under the terms of the shareholder debt or it can reasonably be concluded that the shareholder debt became owing or was permitted because the specified right was or was anticipated to be granted.

These measures will apply to back-to-back shareholder loan arrangements as of Budget Day. For existing back-to-back shareholder loan arrangements, the deemed indebtedness will be deemed to have become owing on Budget Day (thereby seemingly granting taxpayers the ability to unwind the arrangements by the end of the next following taxation year without consequence by way of a *bona fide* repayment). Budget 2016 does not contain any draft legislation in furtherance of this measure.

Multiple-Intermediary Structures

Budget 2016 proposes to clarify the application of the existing back-to-back loan rule to arrangements involving multiple intermediaries. Under these rules, a back-to-back arrangement will comprise all the arrangements that are sufficiently connected to the arrangement under which a Canadian resident makes a cross-border payment or interest or royalties to an intermediary. Where a back-to-back arrangement involving multiple intermediaries exists, an <u>additional</u> payment (of the same character as that paid by the Canadian resident to the first intermediary) will be deemed to have been paid to the ultimate non-resident recipient in the chain of connected arrangements. These measures will apply to the proposed expanded back-to-back arrangement rules relating to royalties as well as the proposed back-to-back shareholder loan rules.

These measures will apply to payments of interest or royalties made after 2016 and to shareholder debts as of January 1, 2017. Budget 2016 does not contain any draft legislation in furtherance of this measure.

OTHER TAX MEASURES

Budget 2016 confirms the Government's intention to proceed with previously announced tax and related measures, as modified, to take into account consultations and deliberations since their announcement or release, relating to:

- Synthetic equity arrangements under the dividend rental arrangement rules;
- The conversion of capital gains into tax-deductible inter-corporate dividends under section 55 of the Tax Act;
- The offshore reinsurance of Canadian risks;
- Alternative arguments in support of an assessment;
- An exception to the withholding tax requirements for payments by qualifying non-resident employers to qualifying non-resident employees;
- The repeated failure to report income penalty;
- The acquisition or holding of limited partnership interests by registered charities;
- The qualification of certain costs associated with undertaking environmental studies and community consultations as Canadian exploration expenses;
- The sharing of taxpayer information with the CRA to facilitate the collection of certain non-tax debts; and
- The sharing of taxpayer information with the Office of the Chief Actuary, among others.

Budget 2016 also announces the Government's intention not to proceed with the measure announced in Budget 2015 that would provide an exemption from capital gains tax for certain dispositions of private corporation shares or real estate where cash proceeds from the disposition are donated to a registered charity or other qualified donee within 30 days.

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